

# Behind Amaranth, A 'Broken' System Senators Find Gaps in Energy-Market Oversight; The CFTC's Uphill Climb and the 'Enron Loophole'

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A Senate report contends that gaping holes in the regulatory oversight of energy markets allowed one large hedge fund to game natural-gas futures prices in 2006, increasing risks for other participants and causing utilities to incur unnecessarily high costs last summer. The report by the Permanent Subcommittee on Investigations, which calls the oversight system "broken," provides a bird's-eye view of trading at Amaranth Advisors LLC, which lost more than \$6 billion last year in the largest hedge fund failure in history. A hearing on the findings is set for today.

It also highlights concern in Washington that financial markets in energy and other sectors are outpacing regulators' ability to keep up. The Commodity Futures Trading Commission, which regulates energy and other futures markets, has an enforcement budget that is about 1/20th the size of its cousin, the Securities and Exchange Commission. In addition, a part of the energy market doesn't fall under the CFTC's jurisdiction, potentially making it more vulnerable to manipulation.

After Amaranth's collapse in September, the Senate subcommittee and federal regulators started examining what happened. The hundreds of pages of data and analysis in the Senate report show what many traders suspected but couldn't prove: Before Amaranth went under, the investment fund held as much as 40% of all open bets on gas contracts at the New York Mercantile Exchange, a unit of Nymex Holdings Inc. that is the world's largest energy marketplace. By virtue of its size, Amaranth had the power to influence market dynamics and the closing prices of some contracts, the subcommittee said.

More important, it contends, Amaranth built greater market dominance with bets on an over-the-counter energy-trading venue, the Intercontinental Exchange Inc., that neither Nymex nor federal futures regulators could see.

The report detailed massive purchases of contracts July 31 on both Nymex and the Intercontinental Exchange, or ICE. That day, the spread, or difference, between gas for delivery in March and April 2007 rose sharply.

The move contributed to the collapse of another fund, Mother Rock LP. Despite a heat wave that also affected prices, the report alleges the "clearest explanation" for the "extreme magnitude" of the swing was Amaranth. A Georgia electric utility has told the committee that, during the spring and summer of 2006, it made trades to lock in prices for gas that ultimately cost it \$18 million. This "resulted in higher natural gas bills for their customers," which it contends is a "premium" forced on them by Amaranth and other speculators, according to the report.

Amaranth released a critique of the Senate report by Chicago economic consultancy Lexecon Inc., saying the statistical analysis was "based on spurious correlations and incomplete data analyses" and failed to establish that Amaranth was the cause of the big price moves. Amaranth also said it didn't "dominate" or "distort" natural-gas trading, that many economists reject the theory that speculators can control prices, and its closure occurred without major repercussions in the broader markets.

Sen. Carl Levin, the Michigan Democrat who heads the permanent subcommittee, and Sen. Dianne Feinstein (D., Calif.) are expected to cite the Senate report's conclusions to bolster a pending bill to do away with the "Enron loophole." That is a provision Congress inserted into the Commodity Futures Modernization Act in 2000, at the urging of the former energy merchant, to exempt electronic energy exchanges from most aspects of federal regulatory oversight.

While at the time the loophole benefited Enron, it has more recently aided the growth of ICE, an exchange popular in part because of the anonymity it offers traders. ICE wasn't required last year to routinely provide the CFTC with data on traders' positions, as is the case with Nymex. ICE began providing it to the CFTC under a special order after Amaranth's collapse. A bill sponsored by Sens. Levin and Feinstein, among others, would make that data-sharing permanent.

Any further scrutiny of ICE also could impact the consolidation taking place among world financial exchanges. ICE and Chicago Mercantile Exchange Holdings Inc. are battling to take over the owner of the Chicago Board of Trade, CBOT Holdings Inc. Both proposals mostly are stock based, so any new rules or findings that hurt ICE's stock price would make the Chicago Merc's offer for CBOT look relatively more attractive in front of a July 9 shareholder vote.

The Senate subcommittee said it wasn't accusing Amaranth or anyone else of manipulating energy prices, which requires showing that someone intended to create an artificial price and succeeded in doing so. Yet it said Amaranth held a tight grip on some markets -- holding nearly 70% of the open bets on Nymex for gas for November 2006 delivery, for example, in February 2006. Nymex has strict rules limiting how many contracts a trader can hold when they are close to expiration, but it has no set position limits in contracts months or years away from closing out.

The subcommittee's minority Republican staff cautioned in a dissent that while they supported regulatory reforms, they were less certain of some findings and that "at least at times, Amaranth was responding to the market, rather than driving it."

Nymex said the report highlights "the advantages of working within a regulated marketplace," and it kept an orderly market during the period of Amaranth's trading. The CFTC said it will testify on the report July 9. An ICE spokeswoman said regulatory controls could push traders to less-transparent markets for privately negotiated derivatives, "where no reporting or antimanipulation obligations exist."

Amaranth is fighting an investor lawsuit and is the subject of unresolved regulatory probes, including one at the CFTC. Its founder and former chief energy trader are trying to start new hedge-fund businesses.

The report also detailed the reluctance of Amaranth's biggest rival, John Arnold of Houston hedge fund Centaurus Energy LP, to bail out the fund when it was looking to unload quickly crashing contracts in September.